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CENTRAL INTELLIGENCE AGENCY
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CURRENT INTELLIGENCE MEMORANDUM

SUBJECT: Middle East Oil Negotiations

1. The lengthy, currently deadlocked talks between representatives of the Western-managed Iranian consortium and those of the Organization of Petroleum Exporting Countries (OPEC) over sharing of oil income are likely to end in a settlement, even though an OPEC meeting in Beirut on 4 December publicly rejected the companies' proposals. In the present instance, negotiations with the consortium are being used as a "test case" by the OPEC countries.

2. The origin of the present debate is in the Middle Eastern producing countries' growing dissatisfaction with their share of the earnings realized by Western companies on the sale of crude and refinery products. Officials of Middle Eastern governments have claimed for some time that the Western companies are obtaining excessive, partly unrevealed, profits. These officials also believe or suspect that the companies are using profits on their Middle Eastern crude production operations, which should be shared with the governments of the area, to support less profitable "downstream" operations--refining, transportation, and marketing--in other parts of the world.

3. Since the mid-1950s, Middle Eastern oil-producing countries have derived their oil revenue according to a so-called "50-50" profit-sharing formula. The basic ingredient of this formula, which is incorporated in the agreements between the companies and the governments concerned, is the

"posted prices" at which the producing companies declare themselves ready to sell crude oil of various grades. Since the end of the Suez crisis of late 1956, posted prices have become increasingly unrealistic. Nearly all buyers, except the proverbial "subsidiaries and fools," receive substantial discounts off the postings. The posted prices have remained significant, however, because they are used instead of the actual selling prices in calculating receipts from the sale of Middle Eastern crude, and, consequently, in calculating the amount of profit to be shared with the governments of the producing countries. A reduction in posted prices by the major international companies in 1960 led to the formation of OPEC, whose members saw their revenues threatened by the companies' unilateral action.

4. OPEC's first aim was to restore posted prices to their former levels. Since world market conditions made this practically impossible, they have subsequently sought to protect or increase their revenues by other means. One of these means is to use a new basis on which to calculate the "net profit" to be shared. Under present arrangements, the governments receive their shares in two parts: first, by "royalty" payments, which generally are about 12.5 percent of posted prices, and, second, by income taxes levied on the producing companies in such amounts that the sum of royalties and taxes totals no more than 50 percent of the net profit. (See Table I) The royalty payments thus are not charged against production costs, but are used in effect as a tax credit.

5. OPEC now seeks to change this practice so that the royalty payments will be included in production costs (this is termed "expensing" the royalties), and so that the governments will receive 50 percent of the remaining profit, without deduction for these royalties. (See Table II) The companies maintain that OPEC's demand for expensing royalties would substantially increase the governments' shares of the net profit. The OPEC, furthermore, wants to raise the royalty rate itself from 12.5 to 20 percent.

6. Inherent rivalries among its members have kept the OPEC from functioning very effectively thus far, but the Middle Eastern countries at least have made an increased effort to keep a solid front during the current talks. The international companies are also competitive with each other, and hold different points of view and interests in dealing with the producing countries. So far, however, they have all avoided recognizing OPEC as the bargaining agent for the oil states and have insisted that OPEC's officers be regarded as representatives of the individual countries, not OPEC. The OPEC representatives are therefore only negotiating de facto with the Iranian consortium. The companies rely on the advantages of a strong legal position and, as a last resort, on their near-total control of world markets to enable them to counter the producing countries' threats of unilateral action.

7. Nevertheless, the relatively low production costs of Middle East oil and the huge investment of Western oil companies in this region are powerful incentives for the companies to reach an accommodation with the producing countries, if at all possible individually rather than through the OPEC.

8. The Middle East producing countries are under some pressure to reach an agreement, notwithstanding the emotional nationalism of some of the Arab OPEC representatives. Most OPEC states have ambitious development programs that are predicated almost completely on an increasing and uninterrupted flow of oil revenues. There are also signs of increased economic awareness among the ruling circles in these countries, especially a realization that all aspects of the oil industry are not as profitable as they thought earlier and that the demand for their oil is not limitless.

9. Inroads into the Western European market--the traditional area for Middle East oil--by Soviet and Algerian crude also tend to weaken the OPEC countries' position, as do the actions of several Western European nations in setting aside a large share of the market for their own coal and natural gas industries.

10. The OPEC members will discuss possible courses of action at their next general conference, scheduled to be held in Riyadh, Saudi Arabia, on 24 December 1963.

COMPARISON OF PRESENT METHOD OF OIL COMPANY - GOVERNMENT PROFIT-SHARING AND METHOD IF ROYALTIES "EXPENSED"

TABLE I

(HYPOTHETICAL CASES)

Present System

$150 -	Sales of crude at posted price
12.5 percent	(Royalty)
$18.75	Value of royalty

$150 - Sales
$ 20 - Cost of production
$130 - Profit

1/2 to govt.	1/2 to company
$65	$65

But company has already paid government royalty of $18.75 so it receives credit for this amount against its 50-percent income tax liability; thus, company pays government: $18.75 in royalty
$46.25 in income tax
$65.00 TOTAL

TABLE II

OPEC "Expensing" System Proposals

Again production (sales) is $150 of which company pays government 12.5 percent or $18.75.

Situation is this:

	$150	- Sales
Less	$ 20	- Prod. costs
Less	$ 18.75	- Royalty
	$111.25	- Profit to be shared 50-50

1/2 to govt.	1/2 to company
$55.625	$55.625

But company has already paid $18.75 royalty so government receives $18.75 royalty and $55.625 profit, or $74.375. Thus in this hypothetical case, the 50-50 split becomes 57 percent in favor of the government, while the company's share is 43 percent.